ACCOUNTING THEORY

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Preface

The rapidly growing literature in the broad area of financial accounting theory has made it difficult, if not impossible, for a student of the subject to assimilate and evaluate the many articles and readings now available without a general frame of reference. Thus, one of the major objectives of this book is to provide this frame of reference to enable the student to obtain a better understanding of the vast number of books and articles on the many controversial topics in the area of accounting theory. An attempt has also been made to evaluate critically many of the divergent points of view. However, the area is still developing rapidly and much research remains to be done. There is no pretense that this is the last word on any subject or even that it presents the best approach in every case. It should be emphasized that, at this level of study, the student should not rely entirely on a single text or book; there is no substitute for a critical analysis of the works and articles of many writers.

This book is designed to provide a frame of reference for senior and graduate courses in accounting theory and for seminars in the theory of income, in asset valuation, and in the history of accounting thought. It should also be useful as a general survey of the field of financial accounting theory and for those who may wish to study for the theory section of the Uniform CPA Examination. The book has been written on the assumption that the reader has a knowledge of the basic framework of accounting usually provided by two years of accounting study or the equivalent. However, experience has indicated that graduate students can handle the subject matter with the equivalent of one year of college accounting and some additional formal or independent study.

The approach to accounting theory presented is based primarily on deductive reasoning and logic starting with the basic objectives and postulates of financial reporting. The theory of income determination is the center of most of the discussions, but it is difficult to discuss the measurement of revenue and asset allocations without also discussing the problems of asset valuation. And some of the objectives of financial reporting can be met by appropriate classifications in the financial state-

ments and by other means of disclosure. Therefore, an attempt has been made to present a complete theory of financial reporting to meet the several objectives generally assumed.

One of the best ways to explore the controversial areas in accounting theory is to start with a review of their historical development. This has been done primarily by a comparison and evaluation of the several pronouncements of the American Institute of Certified Public Accountants and the American Accounting Association and other organizations and societies. The thread of development also becomes apparent by a comparison of the arguments presented over time in many articles and professional books.

Considerable emphasis has been placed on an evaluation of the several sides of current controversial questions. Particular emphasis has been given to discussions of the positions of the AICPA, including the current opinions of the Accounting Principles Board and the Accounting Research Studies of the Accounting Research Division and to the positions of the several Committees on Concepts and Standards of the American Accounting Association. It is suggested that the student obtain copies of these official pronouncements and research studies or have them readily available for study and reference. The author has taken the liberty of expressing preferences in many cases and of presenting his own views. The main reason for taking a position on controversial questions is to permit a consistent application of the theories and ideas presented throughout the entire book and to stimulate independent thought on the part of the reader.

The first four chapters present the general background for the development of accounting theory. These include a chapter on methodology, two chapters on the historical development of theory, and a chapter on postulates. Following these are five chapters presenting the basic framework of accounting theory. Three of these chapters discuss income concepts and price-level adjustments and two treat the problems of asset valuation and classification. The third section contains five chapters that discuss the applications of accounting theory to specific topics relating to apportionments and accruals and the related asset and liability valuations. The final three chapters cover the basic problems of disclosure of relevant financial information to investors, creditors and other interested readers of financial statements.

At the end of each chapter is a list of suggested readings on specific topics. These articles and sections of books have been selected with care on the basis of their general quality and their ability to present the several sides to controversial questions. Where a difficult decision had to be made, the article most likely to be available to students in American colleges and universities was chosen. No doubt, some very excellent articles have been omitted either because of the wealth of material on a specific topic or because of the failure on the part of the author to find and recognize the best. Where this has occurred, I apologize for the omission. It is the hope that these lists will be useful to students and instructors in providing a starting point in researching and studying each topic. There is no substitute for wide reading in the area of accounting theory to obtain the many different points of view found in the literature.

At the end of the book is a group of questions classified by chapter topics selected from the theory section of the Uniform CPA Examinations of recent years. The author wishes to express his appreciation to the American Institute of Certified Public Accountants for their kind permission to reprint these questions.

The author wishes to express appreciation to the many graduate students who have made helpful comments on an earlier draft of several chapters used in a graduate course in accounting theory at Washington State University. I am deeply indebted to Professor Willard J. Graham of the University of North Carolina for his detailed criticisms and comments on the entire manuscript. Many of Professor Graham's ideas have been incorporated in the book although he may not recognize some of them in the way in which they are presented. Perry Mason, to whom this book is dedicated, made detailed comments and criticisms on an early draft of Chapter 7. Much of the enthusiasm for writing this book as well as many of the ideas were generated some years ago in the classrooms and in personal discussions with Maurice Moonitz, C. C. Staehling, and Perry Mason at the University of California, Berkeley. And, of course, this book could not have been written without the continual encouragement and full support of the members of my immediate family—Kathleen, Margot, and Dan.

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CHAPTER 1

The Methodology of Accounting Theory

Probably the most relevant definition of "theory" as it applies to accounting is that theory represents ". . . the coherent set of hypothetical, conceptual, and pragmatic principles forming the general frame of reference for a field of inquiry."[1] Thus, accounting theory may be defined as logical reasoning in the form of a set of broad principles that (1) provide a general frame of reference by which accounting practice can be evaluated and (2) guide the development of new practices and procedures. Accounting theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.

The *Dictionary for Accountants* defines theory as ". . . a set of propositions, including axioms and theorems, which, together with definitions and formal or informal rules of inference, is oriented toward the explanation of a body of *facts* or treatment of a class of concrete or abstract operations."[2] However, two parts of this definition must be qualified with respect to accounting theory. *First,* theory does not explain all accounting practice. Theory is based on logic, and not all practice is logically conceived. But if the emphasis is placed on the explanation of concepts and results rather than on techniques, the definition is generally correct. *Second,* the body of facts being explained by accounting theory can be assumed to be either (1) the financial facts as presented in accounting statements, (2) the concepts implied in the presentation of accounting data, or (3) the economic relationships of firms with other firms, individuals, and the economy as a whole as measured and summarized in accounting statements. Of these three, the first—the explanation of financial facts presented by accountants—is not the function of theory.

[1] *Webster's Third New International Dictionary, Unabridged* (Springfield, Mass.: G. & C. Merriam Co., Publishers, 1961), p. 2371.

[2] Eric L. Kohler, *A Dictionary for Accountants* (2d ed.; Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1957), p. 484.

The "facts" being explained by accounting theory are not independently measurable and verifiable and, therefore, are not really facts. Rather, they are the economic relationships in the business world and concepts such as "value" and "income" that may appear differently to various observers. Thus, several theories may be developed from the same set of "facts" and concepts, each of which may appear logical within the framework of the observations of specific individuals. The choice of a most appropriate theory depends on how well it supports the development of procedures and techniques that best fulfill the objectives of accounting.

One of the first steps in the development of accounting theory, therefore, is a clear statement of the objectives of accounting. In descriptive statistics, a summarized description of a population cannot be made unless the statistician first understands the type of information that is wanted. A description of the height and weight of the individuals in a given country may be of little value to a person who is interested in their economic well-being. Similarly, the type of information useful to management in the making of decisions is not necessarily the same as the type of information needed by stockholders and prospective investors of the firm. Managers need information that will tell them the effect of current decisions on future income. Stockholders who have an effective control of management need information to be able to judge the relative efficiency of management. Stockholders, prospective investors, and creditors need information that will help them predict the future course of the firm and the probability of future financial success. While these objectives may lead to the same accounting principles, different principles may be required to meet the several objectives of accounting. The major emphasis in this book is on the development of financial accounting theory based on the objectives of reporting to stockholders, investors, creditors, and other outside interests, although the objectives of management are frequently taken into consideration.

major emphasis of accounting objective

These objectives have changed over time as one or more of the several interested groups have dominated in their pressure for information from accountants. At various stages in the development of accounting, the owner-manager, the creditor, and the stockholder-investor have each dominated in determining the type of information reported in financial statements. Therefore, a good understanding of current objectives and accounting practices requires a study of the historical development of accounting theory. A summary of this development is, therefore, presented in the following two chapters.

THE SEVERAL APPROACHES TO ACCOUNTING THEORY

Once the objectives of accounting are established, one or more of several approaches to accounting theory must be selected in order to derive logically conceived accounting principles. These objectives, however, may be modified with the development of theory, but a change in the basic objectives might require a reformulation of the entire theoretical structure. For example, one of the objectives of financial reporting might be to provide information to stockholders and other outsiders to permit them to make useful predictions regarding the future operations of the firm. This objective leads to the development of an operating concept of income to the enterprise and to the stockholders. But if the objective should be the measurement of the social benefits of the firm, the measurement of these benefits should include the value added to the economy and all social benefits and costs not measured directly by the mechanism of the market.

Some of the approaches to the development of accounting theory that have been suggested and used include the following: (1) the deductive reasoning and the axiomatic approaches, (2) the inductive approaches, (3) the pragmatic or "common-law" approach, (4) the ethical approach, (5) the use of communications theory, (6) the application of behavioral relationships, and (7) emphasis on sociological factors. None of these approaches or methods, however, is independent of the others. Generally more than one approach is used either explicitly or implicitly in the development of accounting principles. The theory developed and discussed in the following chapters is eclectic in nature, drawing upon all of these various approaches at various points, although the greatest reliance is placed on deductive reasoning.

Deductive Reasoning

The deductive method of reasoning in accounting is the process of starting with objectives and postulates and, from these, deriving logical principles that provide the bases for concrete or practical applications. Thus, the practical applications and rules are derived from the logical reasoning; the postulates and logically derived principles should not merely support or attempt to explain accounting conventions or currently accepted practice.

The structure of the deductive process should include the following: (1) the formulation of general or specific objectives of financial reporting; (2) a statement of the postulates of accounting concerning the economic, political, and sociological environment in which accounting must operate; (3) a set of constraints to guide the reasoning process; (4) a structure, set of symbols, or framework in which ideas can be expressed and summarized; (5) the development of a set of definitions; (6) the formulation of principles or generalized statements of policy derived by the process of logic; and finally (7) the application of the principles to specific situations and the establishment of procedural methods and rules.

In the deductive process, the formulation of objectives is most important because different objectives might require entirely different structures and result in different principles. This is one of the main reasons

why rules for determining taxable income are different in many respects from the generally accepted practice for the determination of financial income. While there may be many advantages in applying the same income concepts to both tax and financial accounting, the basic objectives are different and it is not likely that the same principles and procedures will meet the different objectives equally well. The frequent proposal for a single all-pervasive concept of income also has many advantages, but it does assume that such a concept could serve all accounting objectives equally well. While this is not true, it would not be desirable to set up an entirely different set of principles for every purpose served by accounting. Some compromises must be made, but there should also be some freedom to serve different objectives as well as possible. Thus, accounting theory should be flexible enough to provide the needs of different objectives but rigid enough to provide for uniformity and consistency in financial reports to stockholders and the general public.

The objectives, postulates, constraints, and structural framework will be discussed at greater length in Chapter 4. However, they are all essential to the deductive process. The postulates are not necessarily numerous or complicated; they may even seem trivial or obvious. But it is desirable to make them explicit to provide a framework for subsequent logical reasoning. The constraints are restrictions to the development of principles directly from the objectives and postulates. These restrictions are necessary because of certain limitations of the environment particularly caused by uncertainty regarding the future and changes in the environment such as fluctuations in the value of the measuring unit—money.

Symbols and a general working framework are necessary to provide a means of communication of ideas. In accounting, the framework is the accounting equation and the several derived financial statements. The statements should articulate with each other in order to provide an internally consistent framework.

A more precise method of formulating the symbols, structure, and constraints is found in the axiomatic or mathematical approach to accounting theory. In this method, mathematical symbols are given to certain ideas and concepts. The framework is provided in the form of mathematical models utilizing matrix algebra or linear equations. Constraints can be applied in the form of mathematical expressions. Therefore, starting with basic postulates, axioms can be set up and, with a form of calculus, theorems can be set up and proved. Thus, the axiomatic method can provide a very useful framework for the deductive approach to accounting theory.

One of the main disadvantages of the deductive method is that if any of the postulates and premises are false, the conclusions may also be false. Also, it is thought to be too far removed from reality to be able to derive realistic and workable principles or to provide the basis for practical rules. But these criticisms generally stem from a misunderstand-

ing of the purpose and meaning of theory. It is not necessary that theory be entirely practical in order to be useful in establishing workable procedures. The main purpose of theory is to provide a framework for the development of new ideas and new procedures and to help in the making of choices among alternative procedures. If these objectives are met, it is not necessary that theory be based completely on practical concepts or that it be restricted to the development of procedures that are completely workable and practical in terms of current known technology. In fact, many of the currently accepted principles and procedures are general guides to action rather than specific rules that can be followed precisely in every applicable case.[3]

The Inductive Approach

The process of induction involves the making of observations of detailed measurements and then drawing generalized conclusions or principles from these. Detailed observations are made for a few items, and from these, generalizations are made regarding the entire universe or a group of similar situations. These generalizations, however, are subject to later confirmation or refutation after further experimentation and observation. All principles inductively derived are, therefore, conceptually falsifiable. Thus, through the inductive process, Newton was able to observe the characteristics of motion and from these observations and measurements derive generalizations or laws of motion.

In accounting, the inductive process involves the making of observations of financial data regarding business enterprises. If recurring relationships can be found, generalizations and principles can be formulated. Thus new ideas and principles can be derived, particularly if the observer does not let himself be influenced by current principles and practices. Undoubtedly, there are many financial relationships that may prove beneficial to the users of financial statements in evaluating the operations of the enterprise and in making predictions regarding the future of the firm.

Just because the observer looks only at raw data does not mean, however, that he does not need some initial postulates and concepts. By the mere making of a choice regarding what to observe he is reflecting preconceived notions of what might be relevant. By restricting himself to the financial data of a firm, for example, he is drawing on certain postulates regarding the environment of accounting. Furthermore, if he restricts

[3] For example, the capitalization of long-term leases that are, in substance, a purchase of property, as recommended by the AICPA Accounting Principles Board in *Opinion No. 5,* is a general guide that cannot necessarily be followed with precision in every case, particularly if the lease contract includes the purchase of services acquired jointly with the use of property. See Accounting Principles Board, "Reporting of Leases in Financial Statements of Lessee," *Opinion No. 5.* (New York: American Institute of Certified Public Accountants, September, 1964). Reprinted in *Journal of Accountancy,* Vol. CXVIII (November, 1964), pp. 63–66.

himself to observing only financial transactions, he may only confirm existing practice.

The advantage of the inductive approach is that it is not necessarily constrained by a preconceived model or structure. The researcher is free to make any observations he may deem relevant. But once generalizations or principles are formulated, they should be confirmed by the logical process of the deductive approach. However, the main disadvantage of the inductive process is that the observer is likely to be influenced by subconscious ideas of what are the relevant relationships and what data should be observed. It is difficult to divorce the inductive approach entirely from the deductive method because the latter provides a guide to the selection of the data to be studied.

Another difficulty with the inductive approach is that, in accounting, the raw data are likely to be different for each firm. Relationships may also be different, making it difficult to draw generalizations and basic principles. For example, the relationship between total revenues and costs of goods sold may be a constant over time for some firms, but this does not necessarily mean that the historical gross margin concept is necessarily a good measurement for the prediction of the future operations of a firm in all cases.

The Pragmatic or "Common-Law" Approach

Philosophical pragmatism is ". . . marked by the doctrines that the meaning of conceptions is to be sought in their practical bearings, that the function of thought is as a guide to action, and that the truth is preeminently to be tested by the practical consequences of belief."[4] Thus, the pragmatic approach involves the development of ideas that are in agreement with the real world and find usefulness in realistic situations. As applied to accounting theory, the pragmatic approach involves the selection of accounting concepts and techniques based on their utility. Principles and procedures are held to be useful if they accomplish the objectives of management or if they help stockholders or other readers interpret accounting statements and aid in meeting their specific objectives. Theory that does not have an immediate practical use is assumed to be poor theory.

The method used by the AICPA prior to 1959 (and to a large extent since) in the development of accounting principles was largely pragmatic in approach. Specific procedures or techniques were studied and certain procedures were recommended on the basis of their usefulness without a reliance on a general overall framework of accounting theory and without the necessity for an interdependence of the several procedures recommended in different areas. The principles and procedures recommended, however, gained respectability only if they subsequently became generally accepted. The final proof of the recommendation was, therefore, the usefulness of the procedures in actual practice. Usefulness is assumed by general acceptance.

[4] *Webster's Third New International Dictionary, Unabridged,* p. 1781.

By a reliance on general acceptance, the pragmatic approach leads to a form of "common law" in accounting. That is, principles, procedures, and techniques are considered to be good if there is a precedence for their general acceptance in a given area. Furthermore, acceptance may move into another area if the same type of utility can be found in the new area. For example, LIFO started as an accepted practice in only very restricted areas and only under specific conditions; but the usefulness of the method was soon applied to other areas until it has become a generally accepted procedure in most areas of inventory valuation. As new problems arise, procedures are recommended on the basis of similarities to generally accepted practices. This is similar in many respects to the development of common law over time.

This approach to the discovery of useful accounting methods has occasionally been referred to as an inductive method. Research is directed toward the discovery of which accounting procedures are most commonly used and thought to be the most useful by accountants or users of financial statements. The research method utilizes questionnaires, interviews, and studies of accounting reports and statements. The results of the research method may point out those procedures most commonly thought to be useful, trends toward the general acceptance of newer procedures, or new procedures found useful in a few cases but which may be useful in many others if the advantages are made known.

One of the advantages of the pragmatic approach is that accounting serves a function only if it is useful. If it can be assumed that accountants know what is most useful for their own firms or clients, the most commonly used practices can be assumed to be the best. The pragmatic approach also has an advantage in making known new methods that may prove to be useful to many if widely adopted; and it may lead to greater uniformity and consistency by the widespread adoption of the most useful procedures.

The pragmatic approach, however, has many serious disadvantages. The most serious criticism is probably that there are no basic criteria for determining what is meant by "useful." To whom should accounting data be useful and for what purpose? Reports that fail to disclose certain losses or inefficiencies of management may be considered useful to management but they would not necessarily be useful to stockholders or prospective investors. A clear statement of the objectives of financial accounting must precede an analysis of how specific procedures can help accounting fulfill its functions.

A significant limitation of the pragmatic approach is that generally accepted practice is not necessarily the most useful from the point of view of providing information relevant to good decision making. Many

procedures are widely adopted because they are simple expedients or because they minimize the current payment of the corporate income tax. Just because procedures are widely used does not mean that they are necessarily useful, good, or logical.

While it may be helpful to know what methods are in common use, an investigation of practice is not likely to lead to new theories or ideas or even new procedures. In fact, the publishing of generally accepted procedures and the assumption that these are the best methods known may deter progress. Accountants may rely on the general acceptance of these procedures rather than attempt to experiment or develop better methods.

The Ethical Approach

The ethical approach to accounting theory places emphasis on the concepts of justice, truth, and fairness. DR Scott suggested that the basis for the determination of accounting practice reaches back to the principles underlying social organizations. His basic concepts were: (1) accounting procedures must provide *equitable* treatment to all interested parties; (2) financial reports should present a *true* and *accurate* statement without misrepresentation; (3) accounting data should be *fair, unbiased,* and *impartial* without serving special interests. To these basic concepts he added the requirements that accounting principles should be subject to continual revision as necessary to allow for changing conditions and that accounting principles should be applied consistently whenever possible.[5]

Fairness, justice, and impartiality refer to judgments that accounting reports and statements are not subject to undue influence or bias. They should not be prepared with the objective of serving any particular individual or group to the detriment of others. The interests of all parties should be taken into consideration in proper balance, particularly without any preference for the rights of the management or owners of the firm who may have greater influence over the choice of accounting procedures. Justice frequently refers to a conformity to a standard established formally or informally as a guide to equitable treatment.

Truth, as it relates to accounting, is probably more difficult to define and apply. Many seem to use the term to mean "in accordance with the facts." However, not all who refer to truth in accounting have in mind the same definition of "facts." Some refer to accounting facts as data that are objective and verifiable. Thus, historical costs may represent accounting facts. On the other hand, the term "truth" is used to refer to the valuation of assets and expenses in current economic terms. For example, MacNeal stated that financial statements display the truth only when they disclose the current value of assets and the profits and losses

[5] DR Scott, "The Basis for Accounting Principles," *Accounting Review,* Vol. XVI (December, 1941), pp. 341–49.

accruing from changes in values, although the increases in values should be designated as realized or unrealized.[6]

Truth is also used to refer to propositions or statements that are generally considered to be established principles. For example, the recognition of a gain at the time of the sale of an asset is generally considered to be a reporting of true conditions, while the reporting of an appraisal increase in the value of an asset prior to sale as ordinary income is generally thought to lack truthfulness. Thus, the established rule regarding revenue realization is the guide. But the truthfulness of the financial reports depends on the fundamental validity of the accepted rules and principles on which the statements are based. Established rules and procedures provide an inadequate foundation for measuring truthfulness.

The concept of "fairness" has long been a basic objective in the presentation of audited financial statements. The generally accepted accountant's short-form report or certificate states, in part: "In our opinion, the accompanying statements present *fairly* the financial position of the company as of __________ and the results of its operations for the year then ended . . . ." Mautz and Sharaf indicate that this statement expresses the faithfulness in reporting the realities of the firm's operations and financial condition.[7] In discussing the concept of fairness, they include three subconcepts: accounting propriety, adequate disclosure, and audit obligation.

AICPA Statements on Auditing Procedure No. 33 implies a similar concept of "fairness." In a section entitled "Fairness of Presentation," the topics discussed include (1) conformity with generally accepted accounting principles, (2) disclosure, (3) consistency, and (4) comparability.[8] Thus, the concept of fairness is related closely to compliance with traditional and conventional practice. In this respect, it is similar to the second concept of "truthfulness" stated above. But Mautz and Sharaf imply that compliance is not enough. If compliance with generally accepted practices does not permit the presentation of statements that report the realities, the auditor must develop his own principles. These "realities," however, are similar to the "facts" referred to in the first definition of "truthfulness" above. The determination of realities, like the determination of facts, depends on the viewpoint of the observer.

A different concept of "fairness" is implicit in the comments by Leonard Spacek on AICPA *Accounting Research Study No. 3.* He states:

[6] Kenneth MacNeal, *Truth in Accounting* (Philadelphia: University of Pennsylvania Press, 1939), p. 203.

[7] R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing,* American Accounting Association Monograph No. 6 (American Accounting Association, 1961), p. 158.

[8] Committee on Auditing Procedure of the American Institute of Certified Public Accountants, *Auditing Standards and Procedures,* Statements on Auditing Procedure No. 33 (New York: American Institute of Certified Public Accountants, 1963), pp. 69–74.

> . . . a discussion of assets, liabilities, revenue and costs is premature and meaningless until the basic principles that will result in a *fair* presentation of the facts in the form of financial accounting and financial reporting are determined. This fairness of accounting and reporting must be for and to people, and these people represent the various segments of our society.[9]

Fairness, in this context means impartiality and justice to the individuals and groups having an interest in the statements as well as a fair presentation of the facts. The emphasis is on fairness *to* the readers of the statements rather than fairness *of* the data being presented. Reports that are prepared in a fair manner may also be impartial but, according to Spacek, both are necessary.

Few accountants would deny that truth and fairness are good objectives in the presentation of financial statements. But as single objectives, they rely too heavily on subjective judgments. Because of this subjectivity, there is a tendency to rely on traditional rules and procedures to provide an objective measurement of truth. Unless these rules and procedures are soundly based on logic, however, the resulting statements may turn out to be monstrosities of misrepresentation. In an attempt to present facts and realities, accountants may be likened to the three blind men reported by Confucius as describing an elephant as either like a wall, a tree, or a snake, depending on whether each was feeling the side, the leg, or the trunk of the elephant. The question may be not whether certain information is true or false or fair or unfair but whether or not it is relevant and logical in describing the financial operations and condition of an enterprise.

Probably the greatest disadvantage of the ethical approach to accounting theory is that it fails to provide a sound basis for the development of accounting principles or for the evaluation of currently accepted principles. Principles must be evaluated on the basis of subjective judgments or, as generally occurs, currently accepted practices become accepted without evaluation because it is expedient to do so.

Other Approaches to Theory

Accounting can borrow profitably from other social sciences in establishing a framework for the development of theory and in evaluating the proper objectives of accounting. One of the methodological techniques found useful in other areas is communication theory. While little has been done in applying communication theory to accounting, Bedford and Baladouni suggest an interesting relationship between communication theory and accounting.[10] They claim that accounting may be viewed as

[9] "Comments of Leonard Spacek," in Robert T. Sprouse and Maurice Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises," *Accounting Research Study No. 3* (New York: American Institute of Certified Public Accountants, 1962), p. 78.

[10] Norton M. Bedford and Vahe Baladouni, "A Communication Theory Approach to Accountancy," *Accounting Review,* Vol. XXXVII (October, 1962), pp. 650–59.

an integrated system of the communication process. This communication process involves a determination of what information regarding a firm should be gathered and how it should be interpreted, and the selection of the best method of communication. The process should be evaluated by observing the types of information needed by the users of accounting reports and by determining the ability of the users of the accounting statements to interpret the information properly.

Accounting theory can also draw on a study of behavioral relationships as analyzed in the fields of psychology, sociology, and economics. Accounting is a means for providing information for proper decision making by firms, individuals, and governments. How these individuals and groups react to accounting data should be of direct concern to accountants. A procedure may be conceptually sound but if it leads to erroneous decisions or to undesirable behavior it should be closely scrutinized for possible defects. On the other hand, if certain procedures are adopted only as expedients, they may be useful if their effect is to lead to good decisions and proper behavior. Thus, the emphasis is on how the accounting data are used rather than on the logical development of the reports. While this approach may be useful in research and evaluations, it is similar to the pragmatic approach and is subject to the same criticism that it relies heavily on subjective judgments regarding what behavior is good or appropriate and what is bad or inappropriate. While a behavioral approach is implicit in many discussions of accounting theory, it generally plays a minor role. Prince, however, suggests that motivational postulates should play a greater role in the development of accounting theory, although this theory may rely heavily on the pragmatic approach and deductive reasoning.[11]

The sociological approach is similar to the behavioral approach in that accounting principles are judged by the resulting effects. But the goal is the broader sociological effect rather than the decisions of the immediate users of accounting data. It is more of a welfare approach than the behavioral approach. One of the objectives of accounting is, therefore, the reporting of the effects of business operations on all related groups in society whether or not they are direct users of accounting information. While accountants are not and should not be called upon to make judgments regarding welfare, it is occasionally suggested that accounting reports should provide the information necessary for broad welfare judgments. The main difficulty with this approach is that adequate principles and procedures cannot be established unless accountants have a basis for determining what welfare judgments are important and what information will aid in making these judgments.

[11] Thomas R. Prince, *Extension of the Boundaries of Accounting Theory* (Cincinnati: South-western Publishing Co., 1963).

THE DEVELOPMENT OF ACCOUNTING PRINCIPLES AND PROCEDURES

The critical analysis of accounting principles and procedures presented in the following chapters is based on an eclectic concept of accounting theory. Each of the several approaches to accounting theory has some merit in helping to establish and evaluate accounting principles and procedures. The inductive approach permits a better understanding of the data that provide the foundation for accounting. The pragmatic approach sets certain limitations on the application of abstract theory and helps in establishing the objectives of accounting; for accounting theory must be useful as well as logical. The ethical approach can also be applied in a general way as a basic objective in establishing logical accounting principles and procedures. No one has proposed that accounting statements should reflect information and relationships that are not true, just, or fair. While none of the several approaches to accounting theory is adequate by itself, the most useful framework of an integrated theoretical system is one that is based on deductive reasoning. Therefore, the accounting theory developed and applied throughout this book places its main emphasis on the deductive approach.

The following two chapters present the historical development of accounting theory. While accounting procedures have not always been logically conceived, it is relevant to study their development and change to understand why accounting is what it is today. The historical perspective also permits a better evaluation of the objectives and postulates of accounting theory.

One of the first steps in evaluating accounting theory is to examine the basic postulates on which it is based. A discussion of these postulates is presented in Chapter 4. These postulates include the objectives of accounting, the basic assumptions regarding the economic and political environment of accounting, and the constraints required because of the limitations of measurement, uncertainty, or other pragmatic reasons.

Once the postulates have been presented and discussed, the development of accounting theory requires an analysis of the accounting framework or structure. This framework starts with the accounting equation and incorporates the several financial statements stemming from this initial structure. This entire structure of accounts and statements maintains greater logic and cohesiveness if the statements are made to articulate with each other. Another basic part of this structure is the set of concepts that provides meaning to the statements and the data on which they are based. These concepts must be carefully defined to provide clear logical reasoning in the deductive approach. While a general framework is suggested in Chapter 4, the main development of concepts and definitions is left to later chapters.

Even with a logical development of postulates, accounting framework and definitions, there may be alternative procedures that are logically developed. In these cases, the choice of a best method must be based on how well each satisfies the objectives established. But the effect of alternative postulates and concepts should also be studied. Thus, accounting theory could result in a single set of principles only if there were a single agreed set of postulates including the objectives and constraints and a full agreement on the structure and concepts to be applied. Much of the disagreement in accounting theory is based on a failure to agree on these postulates and concepts. Therefore, one of the functions of theory is to determine the basic nature of the disagreement so that an evaluation can be made at the proper level in the development of the logic.

In each of the following chapters, an attempt is made to develop the basic concepts necessary in the exposition of accounting theory and to evaluate alternative procedures on the basis of the concepts implied and the objectives. In many cases, the author has suggested certain procedures as being superior to others on the basis of specific criteria. The reason for making a choice is to provide an integrated theory throughout all aspects of financial accounting. Each or all of these suggested procedures are subject to further scrutiny and may be rejected even by the author on the basis of changes in the basic postulates, changes in definitions, or changes in objectives.

SELECTED ADDITIONAL READING ON CHAPTER TOPICS

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CHAPTER 2

History and Development of Accounting Theory to 1930

Regardless of the approach selected, an understanding of the current position of accounting theory requires a study of the historical development of accounting thought and practice. Prior to 1930, accounting theory as a well-defined body of logical reasoning did not usually precede accounting practice. Accounting developed historically as the needs arose, and changes occurred gradually in accounting techniques and concepts. But new accounting practices have been necessary to keep pace with changing economic institutions and relationships and the changing objectives of accounting. However, many techniques and concepts continue in use long after the conditions requiring them have ceased.

A need for a study of the history of accounting and accounting theory stems from this relationship with the past. Professors Littleton and Zimmerman stated that ". . . because of the wide availability of a growing technical literature, current accounting thought and actions may draw much more from the ideas accumulated through the past experience of many people than is consciously realized."[1] In all disciplines, theories and concepts are developed in historical continuity. One thought leads to another. Where we are today depends in large part on where we were yesterday. In fact, many of the things we do are based on reasons no longer relevant; we have even lost sight of many of the reasons. We continue in the same way because of a resistance to change. Change requires a reconsideration of where we are and where we are going. In the world of accounting practice, accountants usually do not have the time to stop to evaluate the reasons for their practices. The term "conventional wisdom" coined by Professor Galbraith[2] is very appropriate in its application to accounting. Conventional wisdom is knowledge held because it is generally accepted; deviations from this conventional wisdom do not always

[1] A. C. Littleton and V. K. Zimmerman, *Accounting Theory: Continuity and Change* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1962), p. 271.

[2] John Kenneth Galbraith, *The Affluent Society* (Boston: Houghton Mifflin Co., 1958).